Rittenhouse L.J. – Investing Between the Lines

McGraw-Hill, 2013, [Finance] Grade ★★★★

On the final interview with the department heads of the bank where I was shooting for a position as an assistant portfolio manager 15 years ago, I was asked what I first look for in an annual report. I immediately answered *"the shareholder letter"*. It still is. Being a CEO letter junkie, the latest book from L.J. Rittenhouse, really strikes a nerve. Reading the book is a constant battle against a heavy dose of confirmatory bias. Nevertheless, "*Rittenhouse shows how to make sound judgements (through words) in separating companies that build long-term relationships from those preferring one-night stands*".

Central to the book, and the decade-long effort behind the Rittenhouse Rankings, is the Mungeresque belief that you need several mental models to work out solutions to problems. If you don't have that you will end up in the trap of "to a man with a hammer, every problem looks like a nail". The Rittenhouse Ranking model centers around the seven different areas empirically deemed most important in a quest to analyze corporate communications. At its core, it is a point system that aims to grade a business's likelihood of having a successful sustainable business model by way of analyzing the worded communications out of a company - as opposed to the beaten down track of analyzing companies through the numbers. With a database of over 1000 painstakingly coded annual reports over the last decade, the Rittenhouse Rankings are alone in its kind. *Investing between the Lines* brings this effort to the public for the first time.

As the centerpiece in the construction of the model we find "Capital Stewardship", something that delighted John Bogle when he first studied the model: *"Copernicus-like, it shows the true position of the sun!"* Other factors that are used in the rankings are Strategy-Accountability, Vision-Leadership and Relationships-Candor. *"We have bought into an illusion that the bottom line is the only thing that matters. But where does the bottom line come from? Accounting! Where does that come from? Judgement… What determines judgement? The company values and how they reflect the ethical attitudes of the CEO"*. It makes total sense, of course, but for some reason – finance's obsession with being regarded as a brethren of science – numbers have always been held in higher regard than words within the investment community. However, you would have had a harder time separating the year 2000 versions of Enron and IBM by the numbers, as opposed to a thorough read of the CEO letters. Out of all the critical things to look for in a shareholder letter covered by Rittenhouse, I would highlight a couple: How passionate is the company about meeting the needs of all stakeholders? Also, is the letter written holding candor and sincerity in high regard, or is it merely a long-winded feast of clichés? As they say - using common sense is all too uncommon these days, don't be afraid to trust yours! Finally: The obsession with formulating illuminating wording has been a common denominator of many great CEO letters, including Buffett's of course ("financial weapons of mass destruction"), but also those of Coca-Cola's Robert Goizueta - his 1995 shareholder letter is one of the all-time greats.

As the world is full of failed models but empty of fool-proof ones, this one also has its traps. Here an excerpt from one shareholder letter in 2004: *"Generations of families have worked for XX. Similarly, we have customers and [partners] around the world whose parents, grandparents and great-grandparents have been our customers and [partners]. We look forward to serving their children and grandchildren too. Our customers choose us because they know we stand behind them. We must always live up to that promise and earn their trust"*. Johnson & Johnson? No, AIG. But again, the game of successful investing means finding tools in order to steadily improve one's batting average. It ought not to be a quest for The Holy Grail. One major piece of the puzzle, I believe, is to read (between) the lines of shareholder letters.

To omit careful examination of a CEOs message (or lack of) is lowering your odds of long term success. It is also an area where accumulated knowledge counts. So grab that marker...

Henrik Andersson, March 24, 2013